

Realty Trust Review

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TRUST SHARES FOR YOUR ATTENTION

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REIT CONSTRUCTION, LAND DEVELOPMENT LOANS AT NEW PEAKS: CAPITAL OFFERINGS FALL

The Housing & Urban Development Dept.'s latest data on mortgage REIT holdings underscore our view of REITs as specialists in multi-family and commercial construction lending. They held 18.7% and 17.3% of these two categories in the HUD survey of holdings on March 31, first time REIT holdings have been included in the survey (for earlier data on activity, see RTR June 16). The HUD survey also shows REITs have over one-fourth of all outstanding land loans, although the survey does not show whether they are land development or land acquisition loans. The HUD survey for mortgage REIT holdings on March 31, in billions of dollars:

	<u>All lenders</u>	<u>Mtg. REITs</u>	<u>REIT share</u>
Construction loans			
Single-family	\$7.756	\$0.417	5.3%
Multi-family	10.089	1.888	18.7
Commercial	10.838	1.798	17.3
Total	28.717	4.102	14.3%
Long-term mortgages	444.545	1.555	0.3
Land loans	4.874	1.285	26.4
GRAND TOTALS	\$478.137	\$6.942	1.45%

At the end of March the REITs had \$6.93 billion of commitments to make additional construction loans outstanding, a 1.69-1 ratio of commitments to holdings that is far above the 1.29-1 ratio for all lenders. This indicates continued growth in REIT fundings in near-term quarters.

REITs raised \$263.7 million new capital (equity plus convertible subordinated debt) via public offerings in the June quarter, lowest quarterly total since the \$209.3 million of the September 1971 quarter. Capital included \$148.4 million raised through six initial offerings and \$115.3 million from five second round financings. First half 1972 capital fundings were \$702.1 million, virtually unchanged from the \$707.5 million of 1971.

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A KEENER SENSE OF EARNINGS PER SHARE SHAPING FUTURE TRUST PLANS

Events are closing in on the managers of real estate trusts to force much keener attention to earnings per share numbers than has been evidenced by many trusts until now. No one can safely predict all the ramifications of these changing and sometimes contradictory forces, except to assert they all point to much more effort being expended toward maximizing earnings and dividends per share.

Is this so unusual, because everyone watches earnings per share? Not at all, because trust managers and REIT leaders have in the past been prone to point with pride to graphs tracing steady rises in assets and total capital while only a relatively few at the same time pointed with pride at earnings per share growth. Quite often this was for the very good reason that earnings and dividends per share did not keep pace with asset growth. Many trust managers will challenge our view on this point, but the plain fact is that in trust after trust, assets--and management fees based on total assets--have grown much faster than earnings per share. The coalescing forces can be summarized in this fashion:

1. Searching questions about advisory fee structures. No shareholder questions the fact that he wants talented management working on his behalf in guiding trust affairs but numerous shareholders have come away from recent months with very bad tastes in their mouths. The most vocal shareholders are those who have seen share prices tumble in the wake of sharp quarter-to-quarter earnings declines while management fees remain almost constant. Most recent criticism was provoked by much-maligned Continental Mortgage Investors following its widely publicized earnings decline in the December 1971 quarter. Some angry holders pointed out that the fee to CMI's managers dipped by less than 1% in that December quarter while earnings per share declined 19% from \$0.31 to \$0.25 and share prices tumbled over 27%.

CMI's advisory fee is based upon invested assets, as are nearly all fees in the real estate trust industry. CMI's fee, like that of a majority of other trusts, is based upon the dollar value of closed loans instead of the portion of those loans actually disbursed to borrowers, even though the disbursed portion is the only earning asset. Thus in the December quarter CMI's advisory fee amounted to 1.86% of average outstanding loans, a percentage that is not much different than for nearly all other trusts and in line with CMI's historic average (see page 307 of *THE REAL ESTATE TRUSTS: AMERICA'S NEWEST BILLIONAIRES* for comparisons).

The fee schedule used by nearly all mortgage trusts in effect gives the adviser a much bigger share of profits on trust borrowings than on equity investments. For instance, Continental had a gross return of 10.86% in its March quarter and after advisory fees and expenses, the shareholder received 8.39% net, or 77% of the gross portfolio yield on that portion supported by equity. But when the trust borrows, the shareholder receives only about 40% of the gross yield, while the lender receives about 40% and the adviser retains the same percentage, or about 19%. From the shareholder's point of view, he is splitting the net return on borrowed funds about

two-thirds to one-third with the adviser (forgetting the lender), and in many cases the shareholder gets no more than half the net spread.

A goodly number of shareholders are so concerned they are talking with their lawyers. We don't know if any lawsuits are going to result. Moreover, the rules of the Midwest Securities Commissioners Assn. limit advisory fees to 25% of net income (before depreciation) or 1½% of average invested assets. The 25% limit acts to reduce the amounts which advisers can receive on leverage funds and some trust managements may seek refunds from their advisory companies under this rule. The rule applies generally to trusts making public offerings since August 1969 and has already brought modest refunds for Atico Mortgage, Chase Manhattan Mortgage and Associated Mortgage. All in all, we would expect pressures to continue for lower advisory fees to the benefit of shareholders.

2. A sterner attitude on warrants is developing, and some trusts are using their outstanding warrants as a base for current borrowing. Warrants have been the Achilles heel of the trusts, because the potential dilution and complications they cause for trust managers and present shareholders could not be or was not estimated accurately by the underwriters and sponsors who acquiesced to heavy warrant coverage on initial offerings. Trusts which have subsequently sold convertible debentures with additional warrants may now have two classes of warrants.

Existence of warrants and convertibles thus poses the threat of overhanging but uncertain dilution. Because these instruments may be turned into shares at any time, trust managers cannot really do any accurate projections of dividends and earnings per share. All such estimates are based upon assumptions on conversion and exercise.

The result is that over and over trust managers are vowing to avoid a second or third round of warrants or convertibles. They are becoming much more sophisticated in weighing the cash cost and earnings cost of these packages, and are bargaining harder with underwriters.

A few have tried to convert the dormant longer-term liability of warrants to a current asset by borrowing against the potential funds upon complete exercise. *PNB Mortgage Investors* and *Mortgage Trust of America* are two trusts which have recently completed such agreements, and more are in the works. The typical agreement extends the trust revolving or term credit expiring when the warrants are due to be exercised; this way the trust has use of funds now and does not have to have its funding plans upset by untimely exercise. The stakes for shareholders are huge, for about \$1 billion of warrants currently are outstanding--or about a 17% increase in capital from the REIT's current base of about \$5.6 billion. If these warrants can be converted into earning assets for present shareholders, then everyone will have gained.

3. Higher leverage ratios are on the way. Right now the highest quality short-term mortgage trusts cannot borrow much more than twice their capital. And although some trusts have gotten up to 2.6-1 debt/equity ratios, the 2-1 ratio is still a realistic ceiling for most trusts.

But in many ways the REITs are reminiscent of the early days of the consumer installment finance companies, when their underlying asset was deemed so risky that 2-1 debt/equity ratios were the ceiling. Today the consumer finance companies operate with about 11-1 debt/equity ratio. We think it's only a matter of time before the short-term realty trusts are accorded much higher debt/equity ratios by their commercial bank and commercial paper lenders. This ought to result as the cumulative experience of REITs with construction loans becomes better established.

The higher debt leverage ratios--which are something of a return to fundamentals--should permit trusts to operate for longer periods without returning to the capital markets, and this in turn should stiffen trust resistance to the kooky financing of warrants and convertibles which have diluted current shareholders on an earning per share basis, if not on a book value per share basis. All of this means to us that the infant real estate trusts are nearing an end to some of their sharpest growing pains. Two trusts with interesting potentials in this context are reviewed below:

MIDLAND MORTGAGE INVESTORS SHAKING THE SPECTRE OF FOUR SEASONS

When the Penn Central entered bankruptcy in June 1970 and was quickly followed by Four Seasons Nursing Centers of America, the young realty trusts got a jolt because seven of them had invested in Four Seasons nursing centers. Five trusts held construction loans, most originated by *Midland Mortgage Investors*, which like Four Seasons was headquartered in Oklahoma City.

During the dark days of summer 1970, great numbers of professional investors regarded the Four Seasons debacle as evidence that the real estate trusts weren't viable. As we showed in some detail in our book: *THE REAL ESTATE TRUSTS: AMERICA'S NEWEST BILLIONAIRES*, all the trusts came out of Four Seasons with principal unimpaired and their interest reduced by about 4%. No other lender or shareholder of Four Seasons came out anywhere near whole.

That sequel tells volumes about the safety of secured first mortgages--where trusts have the great majority of assets invested. Bad loans on good real estate seldom turn into disastrous losses. The Four Seasons story is worth repeating for more than historical value. For of all the real estate trusts involved in that first big test for trusts, Midland Mortgage bore the brunt of criticism as the originator of those "bad" loans.

Just the other day, on June 30, Midland ended its third full year with record quarterly earnings of \$0.415 per share, including about 1 3/4-cents per share from the final back interest on Four Seasons loans. Of the original \$1.8 million of Four Seasons loans, MMT has received full principal repayment on about \$800,000 and expects to receive final payment on the remainder during the September quarter under the final reorganization plan confirmed June 26 in Oklahoma City.

While Four Seasons has been winding down, Midland has been making

impressive strides in boosting earnings per share. In the past year, total invested assets rose about 145%, soaring from \$29.11 million to \$71.17 million at fiscal year end. The previous year, the first following the Four Seasons bankruptcy, the trust showed no real net gain in invested assets, and earnings per share reflected it on a quarterly basis. The table shows Midland's progress over the last two years.

MIDLAND MORTGAGE INVESTORS

Statistical Review

--Share amts.--

--Investments--

Quarter	Mil.\$	Yield	Earn.#	Dividend
June '70	\$29.16	13.56%	\$0.33	\$0.33a
Sept. '70	31.72	13.09	0.35	0.34
Dec. '70	32.30	12.30	0.356	0.35
Mar. '71	28.94	12.10	0.365	0.36b
June '71	29.11	11.83	0.29	0.31b
Sept. '71	34.95	13.30	0.344	0.34
Dec. '71	45.68	10.81	0.36	0.35
Mar. '72	61.21	10.62	0.37	0.36
June '72	71.17	10.68	0.415c	0.40

a-Plus \$0.02 extra. b-Includes \$0.087/sh. and \$0.024/sh. capital gains in March and June 1971 quarters respectively. c-Includes \$0.0175/sh. back interest on Four Seasons loans. #-Primary.

loans carry interest rates tied to the prime rate on the last day of each month. The increase in the prime to 5 3/8% on June 30 thus stood to increase total yield by about 3/8% over the previous month for these loans.

To support portfolio growth, the trust has embarked on an aggressive debt leveraging plan combining commercial paper and bank loans. At the end of June the trust had about \$45 million outstanding (\$16 million in commercial paper), for a debt/equity ratio of about 1.41-1. The trust currently has bank lines for \$54 million, including lines to back up commercial paper, at the prime rate with normal compensating balances. The trust says its banks will permit the trust to borrow up to twice its capital (equity and convertible debt) of \$32.2 million, indicating a borrowing limit of about \$65 million. All borrowings cost about 5.63% in the June quarter, up about 5/8% from the previous quarter. Commercial paper is sold directly to the trust, without benefit of dealer assistance.

The projected rate of growth indicates that by the end of the December quarter the trust portfolio will be about \$90 million at which point current debt financing arrangements will be at their practical limits. At that point the trust will have to find additional capital, and management is unable to say what form that might take. At present the trust is committed to minimizing dilution. The trust at present has 1.71 million shares outstanding, with an additional 772,000 reserved for conversion of the \$12.88 million of 7% convertible debentures (convertible at 16.67) and 400,000 shares reserved for exercise of warrants at \$12.50, a low warrant coverage.

This record indicates that Midland has increased its loan originating capacity markedly over the past year, and we estimate the trust's portfolio can grow at about \$10 million net per quarter over the next year. About 80% of loans are being originated by sponsoring Midland Mortgage Company, a mortgage banker with \$300 million in its servicing portfolio. A high proportion of recent commitments have held permanent takeout commitments, and the trust has been able to maintain yields at about 4 1/2% over the prime rate on new commitments. About 75% of

The big question is whether Midland can grow from its present earnings rate of about \$0.40 per share (excluding the Four Seasons back interest) and we believe the answer is affirmative. Earnings gains appear to be certain through the December quarter, when the rate could be in the \$0.43-0.44 range. Although the shape of financing will determine share amounts after that, it appears likely that for fiscal 1973 trust earnings could be in the \$1.70-\$1.75 range, vs. \$1.49 and \$1.25 in the last two years and the dividend could be about \$1.68-1.73. The shares are currently at \$14.88, where they yield an indicated 11.3% minimum on our projections. We believe the shares may receive a higher valuation as the progress becomes better known and look for a price objective in the 17-18 range. Listing on the NYSE is possible. The shares are a sound commitment.

REFINANCING PROVIDES VAST MARKET FOR REALTY REFUND

Here is a trust that does not know how to make a construction loan. The concept of having found an attractive way to provide real estate financing other than construction lending was appealing even before the latest construction lender stumbled. *Realty ReFund Trust* (20-OTC) is strictly in the business of refinancing existing properties. The principals and owners of the adviser know this end of the real estate business by virtue of being property owners and buyers. They know how to appraise, run and buy properties, hence their ability to structure deals from the owner's point of view. So confident were the adviser's principals with their well thought out strategy that four of them put their money where their proverbial mouths were and bought 28,750 units (one share and one warrant) of the trust at \$18.30, the public price of \$20 less commissions. This marks them as one of the very few advisory groups to do so (we know of only three others). This trust is the only one providing refinancing exclusively and the only one doing any volume in that market. Institutional lenders are not oriented to this market.

The market for refinancing is very large potentially. Any property that has increased its profitability is essentially a candidate for refinancing. This also happens to be coupled with the great bulk of past financings done at lower interest costs. It simply boils down to an existing property being able to carry a larger mortgage than the original. The trust has been obtaining its deals primarily through the adviser's extensive contacts in real estate with whom they have dealt in their own real estate activities. Specifically, these are mortgage brokers and mortgage bankers working actively in this type of lending. Brokering these deals is extremely profitable for them. The trust charges no points to the borrower, giving the mortgage broker room to charge his fee. This also means the trust has no form of fee income that can't be duplicated. All the trust's income is interest from its loans. Getting back to the mortgage brokers and bankers, they can boost their servicing portfolios when a paid down loan is refinanced, adding to incentive. Real estate brokers are another source who, understanding what the trust is doing, know where the borrowers are. Finally, the adviser has some strong relationships with several very, very large real estate owners.

Individually a few of them hold properties valued at hundreds of millions of dollars.

The trust refinances a relatively conservative type of property. It tends toward big, middle of the road, gray properties, usually multi-tenanted. Since these have been in existence for some time, there is naturally an operating history on which to base decisions. The portfolio consists mostly of shopping centers, office buildings and large apartment complexes. One motel has been refinanced but under terms which hardly indicate caution has been tossed to the winds. This is owned by Harry Helmsley in Sarasota, Fla. and cross collateralized with six motels. Helmsley's hotel operation is run by Stephen Brenner, one of the most prudent men in the business.

Transactions are basically structured with a view to safety and downside risk, virtually the point of view of a property buyer. Judgment of market value is based on marketable real estate which of course has the record to go on. As buyers, holders and managers of real estate, this feel is sharpened by continuing experience. It is the adviser's opinion that there is as much equity behind the trust's position as the size of the position. The ultimate downside is limited by the probability that properties could be sold for well over the trust's position. As a practical matter, current owners would protect their positions for nothing else than unused cash flow. Income producing property wrap-around loans are the essential type of loan being made although certain types of land leaseback loans (not for development) might be made if the deal could be structured for both parties.

Refinancing is the generic title for the trust's activity while currently the instrument being used almost exclusively is the wrap-around loan. A wrap-around is a junior mortgage loan where the lender takes over the existing first mortgage and lends the borrower an additional amount. The lender (here the trust) pays the first mortgage interest and principal while collecting interest and principal on the new loan. The new loan equals the first mortgage plus the amount advanced by the trust. As a practical matter, Realty ReFund is receiving about 12% on its loaned funds while borrowers pay an effective rate not too much greater on the total wrap than their old first. This technique is particularly useful today because historical interest rates are lower than present rates. As practiced by Realty ReFund, most wraps are drawn co-terminous with the loan being wrapped. The trust uses a small wrinkle here, however, to provide a measure of built-in earnings growth. It sets up the new loan to pay down a little slower than the old. As the loan pays off, income is therefore dropping a little slower than expenses, thereby providing some profit growth. This is a delicate and complex arrangement in the execution. One of the reasons it can be pulled off with relative safety, beyond the necessary real estate expertise to know to what extent the arrangement can be made, is the trust's use of its float. It receives its interest payments by the first of the month while normally payments on the underlying first are not due until month-end. This lets the trust have use of these funds for 30 days on average.

Maturity of loans presently out is about 14-15 years. There is some ballooning at this time when the first and wrap fall due. The probability then is that the wrap will be able to be refinanced on the property's residual earning power. Here the adviser's judgment will tell. The underlying philosophy is that if the building is not worth a reasonable balloon in time, it is not worth anything now. In the meantime, the trust does not have a rollover problem. Appraisal of the shares should therefore be more toward the longer maturity trusts than the shorter term ones, especially since there are no construction loans in its portfolio.

Financing is a flexible affair for the trust. The adviser is open minded as to equity, converts and long-term debt. Short-term debt is only used temporarily until permanent funds come in. The trust has a \$10 million bank credit line but would not like to use more than \$6 million. Permanent financing is being worked on. The trust is looking for \$15 to \$30 million for its second round of financing. The private route is being explored and the form has not been decided. If necessary, small bites of new financing will be taken. Refinancing, as opposed to new ventures, does not require prompt funding as the borrower can wait. In the meantime, a substantial backlog of negotiations in various stages of agreement exists. When financing is obtained, deals can be funded instantly and fully. The trust's financing is of course likely to be equity oriented since it can not go short term and long-term rates are likely to be at the upper end of the scale. With a longer history, it will be in a better long-term borrowing position. It can, however, make a profit for shareholders even if it has to sell equity to yield 10 $\frac{1}{4}$ %.

One criticism we hear leveled at this type trust is that it performs a cash-out service for property owners. While this could be true, the trust's loans are backed by real equity and proven cash flow, a more conservative approach than financing out of original construction costs on new projects. For evaluatory purposes, financing older projects is inherently not much different from financing new ones. The basic tides of inflationary increases or obsolescence will flow through either type over time. The older structure need only maintain its earnings to justify a sensible capitalization price. The new structure may yet have to attain rental occupancy to justify cost. It is in fact more speculative. In a refinancing situation, the investor is simply betting on return and moderate growth, not great appreciation or overages. The adviser's sound stance toward structuring deals and obtaining underlying real estate value seem well suited for this.

The trust now has \$23.5 million funded of which \$19 million represents equity obtained from the original offerings and the balance drawn from bank lines. Loans cover 20 properties in nine states. In the quarter ended April 30, earnings were \$0.45 a share. The current quarter should see improvement to about \$0.50 a share or an annualized rate of \$2.00 conservatively. The shares are thus yielding an estimated 10.0% while selling about 10X earnings. Additionally, the premium over book is only 8%. This seems like good value combined with long term promise.

Written as of noon, Thursday, July 13.